REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

PUBLIC PENSION FUNDS ARE NOT COMPLYING WITH STATUTORY REQUIREMENTS FOR INVESTING IN CALIFORNIA RESIDENTIAL REALTY

P-403

AUGUST 1984

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

P-403

PUBLIC PENSION FUNDS ARE NOT COMPLYING WITH STATUTORY REQUIREMENTS FOR INVESTING IN CALIFORNIA RESIDENTIAL REALTY

AUGUST 1984

Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General
660 J STREET, SUITE 300
SACRAMENTO, CALIFORNIA 95814

Thomas W. Hayes
Auditor General

August 16, 1984 P-403

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning public pension funds' compliance with Sections 13000 and 13001 of the California Financial Code. During our review, we found that only 18 public pension funds met the requirements of the law to invest 25 percent of their new money in investments secured by California residential realty. Further, only 18 public pension funds not meeting the investment requirements complied with the reporting requirements of the law.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

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SUMMARY

Many of the State's 102 independent public pension funds are not complying with the investing and reporting requirements of Sections 13000 and 13001 of the California Financial Code. Since the sections became effective on January 1, 1983, public pension funds have invested a total of $1.5 billion in obligations secured by residential realty in the State. However, if all public pension funds had met the statutory requirement for investing at least 25 percent of their money that became available for investment during the fiscal year (new money) in residential realty, public pension funds would have invested an additional $176.8 million. Further, some administrators for public pension funds that have not met the investment requirement are not submitting required reports to the Governor and the Joint Legislative Audit Committee. As a result, the Legislature does not know whether public pension funds are investing the required percentage of new money in California residential realty.

Sections 13000 and 13001 of the California Financial Code require public pension funds to invest at least 25 percent of their new money in obligations secured by residential realty in the State. The law permits public pension funds to make alternate investments; however, the law requires administrators for public pension funds that do not meet the investment requirement to submit certain reports to the Governor and the Joint Legislative Audit Committee within 10 days after the close of their funds' fiscal year.

To determine whether public pension funds are complying with the requirements of Sections 13000 and 13001, we sent to the 102 independent public pension funds a questionnaire regarding the funds' investments in California residential realty. According to the 83 responses we received, 18 public pension funds, including the State Teachers' Retirement System and the Public Employees' Retirement System, have invested at least 25 percent of their new money in

California residential realty since Sections 13000 and 13001 became effective. Administrators for 8 of the 83 public pension funds claimed that their funds are exempt from the investment requirement. Administrators for the remaining 57 public pension funds stated that their funds have invested little or no money in residential realty in the State. We determined that public pension funds would have invested an additional $176.8 million in residential realty since January 1, 1983, if all public pension funds required to comply with the law had met the investment requirement.

Additionally, responses to our questionnaire indicate that administrators for 18 public pension funds prepared the required reports when their funds did not make the required investments. For 6 other public pension funds that did not make the required investments, administrators did not file the required reports. Thus, the Legislature does not know whether public pension funds are investing the required percentage of new money in California residential realty. Moreover, administrators for only 19 public pension funds stated that they have changed their funds' investment practices as a result of the law.

During our review, we also determined that the State Controller can modify reports on the financial transactions of public pension funds to provide information on the funds' investments in California residential realty. However, because of the time required by the State Controller to process financial transaction reports, the Legislature would receive such information no less than 6 months and as long as 16 months after the close of the State's fiscal year.

INTRODUCTION

California has 102 independent public pension funds; the State, counties, cities, and special districts maintain these funds.* As of March 31, 1984, California's public pension funds held over $51 billion in assets.

On January 1, 1983, Sections 13000 and 13001 of the California Financial Code became effective. Section 13000 requires the administrators of any public pension or retirement fund to give first priority to investing at least 25 percent of all money that becomes available for investment in a fiscal year (new money) in residential realty in the State.** However, Section 13000 permits a public pension fund to make alternate investments if the funds' administrators determine that complying with this section will result in lower overall earnings or less security than the fund could obtain from other types of investments. In such cases, the public pension funds' administrators must submit to the Governor and the Joint Legislative Audit Committee a report of the determination as well as a description of the type, quantity, and yield of the alternate investments. The administrators are to submit this report within 10 days after the close of their public pension funds' fiscal year.

*In this report, we use the term "public pension funds" to refer to all California public pension or retirement funds that invest their money independently of any other fund.

**The term "residential realty" refers to obligations secured by residential realty.

Section 13001 of the California Financial Code excludes public pension funds with annual growth in assets of less than $15 million from the requirement that public pension funds invest at least 25 percent of their new money in California residential realty. A public pension fund with growth in assets of less than $15 million may be excluded from the requirement if administrators for the fund determine that complying with the investment requirement would create an undue burden on the fund because of the fund's limited investment capabilities. The administrators for the public pension fund must send a report of their determination to the Governor and the Joint Legislative Audit Committee.

SCOPE AND METHODOLOGY

The Legislature requested that we notify all public pension or retirement funds in the State of the requirements contained in Sections 13000 and 13001 of the California Financial Code. The Legislature also asked us to determine what changes have taken place in the investment practices of public pension funds as a result of these requirements. In addition, we were to determine how the State Controller can modify his reports on the financial transactions of public pension funds to include information about the funds' investments in residential realty in the State.

In order to notify public pension funds of the requirements of the law, we sent a letter to each of the 102 independent public pension funds in the State. We also sent a questionnaire to each fund so that we could determine how much money public pension funds have invested in residential realty in the State and whether administrators for public pension funds have changed their funds' investment practices since the law became effective. On the questionnaire, we asked administrators of public pension funds operating on a fiscal year ending December 31 to provide information on their funds' investments in California residential realty for the year ending December 31, 1983. We asked administrators of public pension funds operating on a fiscal year ending on another date to provide information on their funds' residential realty investments through March 31, 1984. At the end of our fieldwork on June 29, 1984, administrators for 83 public pension funds had responded to our questionnaire.

We independently verified at least $83 million of the investments in California residential realty that administrators for six public pension funds reported on the questionnaire. To determine whether administrators for public pension funds have changed their funds' investment practices as a result of the law, we interviewed administrators for public pension funds, reviewed investment documents of public pension funds, and analyzed responses to our questionnaire.

Finally, we interviewed the chief of the Bureau of Retirement Reporting and other staff at the State Controller's Office to determine how the State Controller can modify financial transaction reports to provide the Legislature with better information on the realty investments of public pension funds. We discussed our analysis with officials in the State Controller's Office and considered their comments.

ANALYSIS

I

NOT ALL PUBLIC PENSION FUNDS COMPLY WITH THE INVESTING AND REPORTING REQUIREMENTS OF THE CALIFORNIA FINANCIAL CODE

According to the 83 responses to our questionnaire, only 18 of the 83 public pension funds invested at least 25 percent of their money that became available for investment (new money) in California residential realty during the funds' last full fiscal year. In addition, administrators for only 18 of the public pension funds that did not make the required investments have filed the required reports. If all public pension funds had invested at least 25 percent of their new money in California residential realty as required by Sections 13000 and 13001 of the California Financial Code, public pension funds would have invested an additional $176.8 million in residential realty since January 1, 1983. Further, if administrators for all public pension funds that did not make the required investments had submitted the required reports, the Legislature would be better informed about which public pension funds are meeting the investment requirement.

Not All Public Pension Funds Invest the Required Amount in California Residential Realty

The 83 responses to our questionnaire indicate that 24 public pension funds have a fiscal year ending December 31. Administrators for these public pension funds were able to provide information about their funds' investments for an entire year of operations since Sections 13000 and 13001 of the California Financial Code became effective. Most of the remaining 59 public pension funds operate on a fiscal year ending on June 30. At the time of our review, these funds had not operated under the law for a full fiscal year. Therefore, administrators for these public pension funds could not give us complete information on their funds' investments in California residential realty.

Of the 24 public pension funds operating on a fiscal year ending December 31, 9 had annual growth in assets of more than $15 million. These public pension funds had $387 million in new money during the year, and they invested $112 million of this new money in residential realty in the State. Seven of the 9 public pension funds invested the minimum of 25 percent of their new money in residential realty in the State. One of the 9 public pension funds used only 17.6 percent of its new money for such investments. The remaining public pension fund did not invest any of its new money in California residential realty. The other 15 of 24 public pension funds had annual growth in assets of less than $15 million. These public pension funds

had $61.8 million in new money during 1983, and they invested $13 million in California residential realty. However, only one of the 15 public pension funds invested at least 25 percent of its new money in residential realty.

Of the 59 public pension funds operating on a fiscal year that ends on a date other than December 31, 45 public pension funds reported an annual growth in assets of less than $15 million. Four of the 45 public pension funds made the required investments. The remaining 14 of 59 public pension funds reported growth in assets of more than $15 million. Administrators for these 14 public pension funds reported that from January 1, 1983, through March 31, 1984, their funds had approximately $6.3 billion in new money. These public pension funds invested $1.4 billion of that money in residential realty in the State. However, administrators for only 6 of the 14 public pension funds reported that their funds had invested at least 25 percent of the funds' new money in residential realty in the State during the current fiscal year. The 6 public pension funds that met the investment requirement include the State Teachers' Retirement System and the Public Employees' Retirement System. The remaining 8 of 14 public pension funds invested little or no money in residential realty; administrators for these funds contend that their funds are exempt from the investment requirement.

Of the eight public pension funds claiming exemption from the investment requirement of Section 13000, three funds invested 10.2,

4.2, and 0.5 percent of their new money in residential realty in the State. Administrators for these and four other public pension funds told us that their pension funds are exempt from the law because the funds are governed by the city charters under which the funds were established. According to an opinion issued by the Legislative Counsel in December 1982, Sections 13000 and 13001 of the California Financial Code do not apply to retirement or pension funds that were established by the charters of chartered cities. The remaining public pension fund claiming exemption is the University of California Retirement System. This public pension fund did not invest in California residential realty because, in its general counsel's opinion, the management of the university's retirement system is an internal university affair. The general counsel for the retirement system also said that Article IX, Section 9, of the California Constitution vests in the Regents of the University of California "full powers of organization and government, subject only to such legislative control as may be necessary to ensure the security of its funds...." The general counsel believes that, because Sections 13000 and 13001 do not relate to the security of the university's funds, the Legislature may not designate the types of investments that the University of California Retirement System must make.

Our analysis of the responses to our questionnaire indicates that public pension funds with growth in assets of at least $15 million invested nearly $1.5 billion in residential realty in the State since Sections 13000 and 13001 became law. In addition, 60 public pension

funds with growth in assets of less than $15 million invested $22 million since January 1, 1983.

Not All Public Pension Funds File the Required Reports

According to the responses to our questionnaire, administrators for some public pension funds did not submit required reports to the Governor and the Joint Legislative Audit Committee within 10 days after the close of their funds' fiscal year. At the time of our review, 18 public pension funds had invested 25 percent of their new money in California residential realty as required by Sections 13000 and 13001 of the California Financial Code. In addition, administrators for 18 public pension funds that had not met the investment requirement filed reports stating that meeting the requirement would create an undue burden on their pension funds. Further, administrators for most public pension funds that have not met the investment requirement still have an opportunity to meet the reporting requirement after the close of their fiscal year. However, for 6 public pension funds that completed their fiscal year without making the required investments, administrators did not file the required reports.

The reports by administrators of public pension funds provide the Legislature with information about which pension funds have not met the investment requirements of Sections 13000 and 13001. If administrators for all public pension funds do not file the required

reports, the Legislature may be led to believe erroneously that public pension funds are investing more money in California residential realty than they actually are.

Not All Administrators Have Changed Their Funds' Investment Practices as a Result of the Law

On the questionnaires we sent to public pension funds, we asked administrators to indicate whether they had changed their funds' investment practices after Sections 13000 and 13001 of the California Financial Code became effective. Because administrators for public pension funds did not keep records of their funds' investments in California residential realty before January 1, 1983, we were unable to compare the amount of money that the funds currently invest in California residential realty with the funds' past investments in such realty. However, according to the questionnaire responses, few administrators have changed their funds' investment practices to include more investments in California residential realty.

Administrators for 19 of the 83 public pension funds from which we received responses stated that they had changed their funds' investment practices. Administrators for 2 of the 19 public pension funds told us during interviews that they changed their funds' practices to include more investments in California residential realty. Further, administrators for 4 other public pension funds said that they would continue to invest in residential realty if such investments will

provide equal or better yield and security as other investments available to their pension funds.

Administrators for 41 public pension funds responded on their questionnaires that they had not changed their investment practices since January 1, 1983. Also, as discussed earlier, administrators for 8 public pension funds told us during interviews or in documents in addition to their questionnaires that their funds are exempt from the investment requirement; therefore, these administrators claim that they are not required to change the investment practices of their public pension funds. Further, the chief of the accounting division of the Public Employees Retirement System (PERS) responded that the investment practices of PERS did not change because investors for PERS have always invested in California residential realty.

If administrators for public pension funds had changed their funds' investment practices as a result of the law, public pension funds would have invested more of their new money in California residential realty. Public pension funds invested approximately $1.5 billion in California residential realty since January 1, 1983; however, public pension funds would have invested at least an additional $176.8 million if those funds required to comply with Sections 13000 and 13001 had invested at least 25 percent of their new money in California residential realty.

CONCLUSION

Not all of California's 102 independent public pension funds are complying with the investing and reporting requirements of Sections 13000 and 13001 of the California Financial Code. Administrators for 83 public pension funds responded to our questionnaire regarding their funds' investments in California residential realty since the law became effective in January 1, 1983. According to the administrators' responses, only 18 of the 83 public pension funds have invested at least 25 percent of their money that became available for investment during the fiscal year in California residential realty. Further, administrators for 6 public pension funds did not file the required reports with the Governor and the Joint Legislative Audit Committee when their funds did not comply with the investment requirement. As a result, the Legislature does not know that some public pension funds are not making the required investments.

Responses to our questionnaire also indicate that administrators for only 19 public pension funds have changed their funds' investment practices since January 1, 1983, to include more investments in California residential realty. Administrators for many other public pension funds stated that they did not change their funds' investment practices as a result of the law. If administrators for all public pension

funds required to comply with Sections 13000 and 13001 had invested at least 25 percent of their funds' new money in California residential realty, public pension funds would have invested an additional $176.8 million since January 1, 1983.

II

THE STATE CONTROLLER CAN MODIFY REPORTS ON PUBLIC PENSION FUNDS

The financial transaction reports submitted each year by administrators of public pension funds to the State Controller do not provide information on the funds' investments in California residential realty. The State Controller could modify the forms for the reports so that pension fund administrators provide such information. However, information on residential realty investments by the pension funds, like other information currently contained in the financial transaction reports, would not be available to legislators until approximately 6 to 16 months after the close of the State's fiscal year.

Sections 7501 through 7504 of the California Government Code require administrators of public pension funds to file reports of their funds' financial transactions with the State Controller. Administrators must file these reports within six months after the close of their funds' fiscal year. These reports enable the State Controller to compare and evaluate public pension funds and to ensure the safety of members' money. The reports provide information on the assets, liabilities, revenues, expenditures, investments, and fund balances of public pension funds. However, the forms for these reports do not ask administrators to provide information on how much money the public pension funds invested in California residential realty, nor do the forms ask administrators to report the amount of money that became

available for investment during their funds' fiscal year. After administrators for all of the public pension funds file the financial transaction reports, the State Controller compiles the information to produce the Annual Report of Financial Transactions, Public Retirement Systems. The State Controller publishes the annual report about 10 months after the close of the State's fiscal year.

To obtain information on how much money public pension funds have invested in California residential realty, the State Controller could request administrators for each pension fund to provide such information in the fund's financial transaction report. The State Controller could then include that information in the Annual Report of Financial Transactions, Public Retirement Systems. This information could be either a detailed or a simple statement of whether the public pension fund invests at least 25 percent of its new money in California residential realty. However, because of the time required to produce the State Controller's annual report, the Legislature would not receive this information until approximately 16 months after the close of the State's fiscal year. In addition, obtaining the additional information would cause the State Controller to incur additional expenses for redesigning the forms for the financial transaction reports and for reprogramming the State Controller's computer system to include the information.

As an alternative to including in the annual report information on Public Pension funds' investments in residential realty, the State Controller could include such information in a special report to the Legislature. While this alternative would cause the State Controller to incur the initial expenses of redesigning the report forms and possibly of reprogramming the State Controller's computer system, a special report by the State Controller could provide the Legislature with the information approximately six or seven months after the close of the State's fiscal year.

As described in the introduction to this report, Sections 13000 and 13001 of the California Financial Code require administrators of each public pension fund to report to the Governor and the Joint Legislative Audit Committee within 10 days after the close of the funds' fiscal year if the funds do not invest at least 25 percent of its new money during the fiscal year in California residential realty. The law also requires the Joint Legislative Audit Committee to submit an Auditor General's report to the Speaker of the Assembly and the Senate Rules Committee within 40 days after the conclusion of the State's fiscal year. The Auditor General's report will list the public pension funds that reported according to the requirements of Sections 13000 and 13001 of the California Financial Code; however, the report will not show how much has been invested nor how much new money was available for investment. The Speaker of the Assembly and the Senate Rules Committee will then send the report to the affected policy committees. The appendix to this report satisfies

the statutory requirement that the Auditor General prepare a report for fiscal year 1983-84 on the public pension funds that reported they did not invest at least 25 percent of their new money in California residential realty.

CONCLUSION

The State Controller can modify the financial transaction reports of public pension funds to provide the Legislature with information on how much money public pension funds are investing in California residential realty. However, because of the time required by the State Controller to process financial transaction reports, the Legislature would not receive the information until approximately 6 to 16 months after the close of the State's fiscal year.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Thomas W Hayes

THOMAS W. HAYES
Auditor General

Date: August 13, 1984

Staff: Eugene T. Potter, Audit Manager
Anthony F. Majewski
Donald A. Davison

GEORGE DEUKMEJIAN, GOVERNOR

State and Consumer Services Agency

OFFICE OF THE SECRETARY
915 Capitol Mall, Suite 200
Sacramento, CA 95814

(916) 323-9493
TDD: (916) 323-6975

August 8, 1984

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Hayes:

Auditor General Report P-403

Thank you for the opportunity to respond to your audit, "Public Pension Funds Are Not Complying With Statutory Requirements for Investing in California Residential Realty." Although your report did not clearly state their compliance, I am informed by both the State Teachers' Retirement System (STRS) and the Public Employees' Retirement System (PERS) that both have complied with California Financial Code Section 13000 by investing new money in California residential loans for the fiscal year ended June 30, 1984. I have no other comments to make except that clarity with respect to which funds have complied would have been helpful.*

Both Systems continue to comply with legislative direction consistent with sound investment practices.

Sincerely,

A. A. PIERCE
Undersecretary

AAP:jk

cc: Rick Cohen, STRS
Sid McCausland, PERS

* Auditor General's Comment: The text has been changed to show that STRS and PERS have complied with the California Financial Code Section 13000.

APPENDIX

PUBLIC PENSION FUNDS THAT REPORTED ACCORDING TO THE REQUIREMENTS OF SECTIONS 13000 AND 13001 OF THE CALIFORNIA FINANCIAL CODE

The public pension funds listed below complied with the reporting requirements of Sections 13000 and 13001 of the California Financial Code. This list satisfies the statutory requirement for the Auditor General to prepare a report on those public pension funds that reported they did not invest at least 25 percent of their new money in obligations secured by residential realty in the State.

Public pension funds that reported according to the requirements of Section 13000:

None

Public pension funds that reported according to the requirements of Section 13001:

Imperial County Retirement Board
Lindmore Irrigation District
County of Mendocino Employees Retirement Association
Sonoma County Employees Retirement Association
Rainbow Municipal Water District
Pasadena Fire and Police Retirement Board
Service Retirement Fund of the City of Santa Barbara
Long Beach Public Transportation Company Retirement Plan
Stockton Metropolitan Transit District
City of Adelanto
Southgate Recreation and Park District
Valley Center Municipal Water District
Yuima Municipal Water District
Mesa Consolidated Water District
Lakeside Irrigation Water District
Golden Gate Transit - Amalgamated Retirement Board
Sacramento Regional Transit District
Stanislaus County Employees Retirement Association

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
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Assembly Majority/Minority Consultants
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